Office of Chief Counsel
Internal Revenue Service

Memorandum

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subject: Income tax consequences of acquiring of carbon offset credits from a government

This advice may not be used or cited as precedent.

ISSUE

When the California Air Resources Board grants carbon offset credits to the operator of an offset project, must the operator include the value of the credits in its gross income?

CONCLUSION

Yes, the operator must include the value of the credits in its gross income upon grant.

FACTS

The California Global Warming Solutions Act of 2006,[1] aimed at addressing the global warming issue, authorizes the California Air Resources Board (CARB) to promulgate rules and regulations on programs to limit and reduce greenhouse gas (GHG) emissions in such manner that the emissions from all sources within the state will return to their 1990 levels by 2020. Among the programs developed by the CARB under the 2006 Act is the Cap-and-Trade Program (Program).[2]

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[1] 2006 Cal. Legis. Serv. Ch. 488 (A.B. 32) West, codified at Cal. Health & Safety Code Div. 25.5 (West 2014).
[2] See generally Cal. Code Regs. tit. 17, §§ 95801 through 96022.

The Program sets "a firm cap on statewide GHG emissions while employing market mechanisms to cost-effectively achieve the emission-reduction goals."[3] The Program places a statewide "cap" on GHG emissions from large industrial facilities, utilities, electricity generators, and distributors of natural gas and other types of fuel, that is, business entities that are identified as major sources of GHG emissions. In accordance with the statutory goal of reducing the GHG emissions throughout the state, the "cap" is lowered gradually between 2013 and 2020.

A business entity subject to the cap is required to surrender one compliance instrument (which may be an allowance or an ARB offset credit) for every ton of GHGs that it emits for each year. The business entity, if eligible, may be allocated some allowances by the CARB, free of charge. In addition, the entity may be able to buy additional allowances at a CARB-hosted auction or from other entities or buy offset credits. An "allowance," issued by the CARB, is a tradable authorization to emit one metric ton of carbon dioxide equivalent. Also issued by the CARB, an "ARB offset credit" is a tradable compliance instrument that represents a GHG reduction or GHG removal enhancement of one metric ton of carbon dioxide equivalent.[4]

ARB offset credits are issued to approved offset projects only. An offset project consists of "all equipment, materials, items, or actions that are directly related to have an impact upon GHG reductions, project emissions or GHG removal enhancements within the offset project boundary."[5] To obtain CARB approval and eventually receive ARB offset credits, an offset project must be implemented in accordance with one of the offset protocols approved by the CARB as well as with relevant rules and regulations promulgated by the CARB. An offset protocol is "a documented set of procedures and requirements to quantify ongoing GHG reductions or GHG removal enhancements achieved by an offset project and calculate the project baseline."[6] It is designed to ensure that the GHG reductions or GHG removal enhancements are "real," "additional," "quantifiable," "permanent," "verifiable" and "enforceable."[7] To date, the CARB has approved six types of offset protocols.[8] An offset project's compliance with a CARB-approved offset protocol is then verified by an independent verification service. Upon successful verification, the CARB issues one or more ARB offset credits to the operator of the offset project.[9] Once issued, the ARB offset credits may be sold, traded, or transferred, unless they have been retired, surrendered for compliance or otherwise

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[3] CARB, Cap-and-Trade Regulation Instructional Guidance, Ch. 1 (Sept. 2012), available at https://www.arb.ca.gov/cc/capandtrade/guidance/chapter1.pdf.
[4] See Cal. Code Regs. tit. 17, § 95802 (ARB Offset Credit).
[5] Id. (Offset Project).
[6] Id. (Offset Protocol, Compliance Offset Protocol).
[7] Id. (ARB Offset Credit). See also id., for the definition of each term of art.
[8] See Compliance Offset Protocols (available at https://ww2.arb.ca.gov/our-work/programs/compliance-offset-program/compliance-offset-protocols).
[9] For general requirements and processes leading to the issuance of an ARB offset credit, see Cal. Code Regs. tit. 17, §§ 95970 through 95981.

used, have been invalidated by the CARB, or are placed in a buffer account as required by a CARB regulation.[10]

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code[11] provides that gross income means "income from whatever source derived," except as otherwise provided by a Code provision. Gross income includes income realized in any form, whether in money, property, or services. See Treas. Reg. § 1.61-1(a). This definition encompasses all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). The Supreme Court of the United States "ha[s] repeatedly emphasized the 'sweeping scope' of [section 61] and its statutory predecessors." Commissioner v. Schleier, 515 U.S. 323, 327 (1995). The Court "ha[s] also emphasized the corollary to [section] 61(a)'s broad construction, namely, the 'default rule of statutory interpretation that exclusions from income must be narrowly construed,'" Id. at 328 (citations omitted). No Code provision allows a taxpayer to exclude the value of privileges granted by a government from gross income. Relevant caselaw and the Service's long-standing revenue ruling, discussed below, reflect this point.

Baboquivari Cattle Co. v. Commissioner, 135 F.2d 114 (9th Cir. 1943), concerned includibility of payments the taxpayer received from the federal government under the Soil Conservation and Domestic Allotment Act for improving parts of its cattle ranch (consisting of the taxpayer's own land and the land leased from the state of Arizona). The taxpayer decided to make the improvements because heavy rainfalls had frequently caused substantial erosion of those parts. The taxpayer then applied for, and received, the payments under the Act. The taxpayer argued for exclusion of these payments from its gross income on grounds that they constituted "capital subsidies" for the taxpayer's positive outlays and not "income subsidies" that would replace income it would forgo in case of inaction. The taxpayer also claimed that the conservation program at issue was to promote the general good and not for the benefit of the individual and that the payments under the program should not be subject to federal income taxation.

The Court of Appeals for the Ninth Circuit in Baboquivari held that the payments were includible in the taxpayer's gross income. Rejecting the first of the taxpayer's arguments, the court noted that no statute or regulation supports the distinction between "capital subsidies" and "income subsidies" under the conservation program and that the taxpayer earned the payments from the federal government, without restriction, by complying with conditions set for proper use of its land and that the payments were granted without restriction. See id. at 115-116. Dismissing the taxpayer's second argument, the court explained that "the mainspring of the activities of the individual

[10] See Cal. Code Regs. tit. 17, § 95984.
[11] All references to "section" are to the corresponding section of the Internal Revenue Code of 1986, as amended.

recipient is self-interest. The improvement he makes is of advantage to himself in the conduct of his affairs, and he, not the public, gets the money for participating in the land conservation program." Id. at 116.

The holding in Baboquivari remains in force. In Ginsburg v. U.S., 922 F.3d 1320 (Fed. Cir. 2019), the taxpayers voluntarily participated in a New York state brownfield redevelopment program and, in return, received a tax credit against their New York state tax liabilities. Under the terms of the program, any excess of the credit over the state tax liabilities was paid to the taxpayers in cash. The appellate court agreed with the Court of Federal Claims that the taxpayers had an undeniable accession to wealth when they received the excess amount of the tax credit and had complete dominion and control over the payment. The appellate court held that the payment was includible in the taxpayers' gross income, noting that it represented neither return of capital nor reduction in cost basis under the common law doctrine of inducement.

The caselaw is consistent with the Service position expressed in Rev. Rul. 60-32, 1960-1 C.B. 23. In that Revenue Ruling, the Service considered the proper tax treatment of federal payments made to farmers under the Soil Bank Act. The Act provided compensation (in money, in crops, or in credit toward Commodity Credit Corporation loans) to producers of the crops of specified commodities if they participated in the acreage reserve program and voluntarily reduced their acreage of those commodities below certain levels. The Service held that the compensation to farmers (1) was includible in their gross income and (2) would be treated as self-employment income under Chapter 2 of the Code. Although the Service once proposed obsoleting the second holding of Rev. Rul. 60-32,[12] the first holding remains intact and accurately represents the Service position that the receipt of money or valuable property from a government as compensation for agreed performance constitutes an undeniable accession to wealth for the recipient.

It is true that the Service has treated the federal government's grant of valuable permits and privileges as nontaxable in certain instances. See Rev. Rul. 67-135, 1967-1 C.B. 20 (speculative oil and gas leases); Rev. Rul. 92-16, 1992-1 C.B. 15 (sulfur dioxide emission allowances); GCM 39606 (Feb. 27, 1987) (aircraft takeoff and landing slots). Rev. Rul. 67-135 concerns the lease by the U.S. Bureau of Land Management (Bureau) of oil and gas rights on federal lands that were not known to contain producing oil or gas fields. The Bureau granted leases to eligible applicants without competitive bidding, conducting lotteries in instances where there were two or more applicants for an available parcel. The ruling states that the lotteries were merely an impartial method of selecting a lessee. Accordingly, the excess, if any, of the fair market value over the cost of an oil and gas lease was not a prize under section 74(a) and was not includible in the gross income of the lessee under section 61.

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[12] See Notice 2006-108, 2006-2 C.B. 1118. Although Notice 2006-108 proposed a revenue ruling that would obsolete Rev. Rul. 60-32 with respect to its second holding, the Service has not issued any such ruling.

Rev. Rul. 92-16 holds, without analysis, that the allocation by the Environmental Protection Agency of transferable sulfur dioxide emissions allowances and a utility's receipt of them did "not cause the utility to realize gross income" and that the utility's basis in the allowances is not measured by reference to the fair market value of those allowances.

GCM 39606 involves the grant of airplane takeoff and landing rights (referred to as FAA slots) under Federal Aviation Administration rules. Under those rules, commercial airlines and other persons were allowed to purchase, sell, lease, and trade FAA slots at certain high volume airports. Citing Rev. Rul. 67-135 as well as a number of revenue rulings that address the questions of basis and capitalization of costs for an asset acquired directly from a governmental entity, the memorandum reasons that FAA slots, like the rights and privileges in the cited authorities, were conferred in furtherance of government regulatory policies allocating a limited resource, and that there was a determination in each case only to tax net income attributable to such governmental licenses and permits as, and if, the recipient realized income through their use or disposition. The memorandum concludes that the grant of FAA slots is "not an event that results in the realization of gross income."

The Service treats a state tax credit granted to a taxpayer as a reduction in state tax or recovery of state tax paid, not as an item of income, to the extent that the credit is used to reduce the taxpayer's tax liability. See, e.g., Rev. Rul. 79-315, 1979-2 C.B. 27 (Iowa income tax rebate for 1978); Rev. Rul. 70-86, 1970-1 C.B. 23 (California real property tax rebates). Any part of the credit that is refunded to the taxpayer or sold for consideration has been treated as includible in the taxpayer's gross income. See, e.g., Rev. Rul. 78-194, 1978-1 C.B. 24 (New Jersey homestead tax rebates). In Tempel v. Commissioner,[13] the Tax Court adopted the Service's approach. In Tempel, the taxpayers received refundable state income tax credits for making conservation easement donations and, in the same taxable year, sold them to third parties. Considering the tax consequences of the taxpayers' sales, the Tax Court stated that while the state income tax credits, if used to reduce state income tax liabilities, would not be includible, the taxpayers in that case experienced an undeniable accession to wealth because they sold the credits for cash. See generally 136 T.C. at 351.

An operator of an offset project enjoys an undeniable accession to wealth when granted ARB offset credits by the CARB. See Glenshaw Glass Co. at 431. Moreover, the operator has complete control over the ARB offset credits upon grant. The operator may sell, trade or transfer their ARB offset credits at any time and without any restriction.

The taxpayers in Baboquivari, Ginsburg, and Rev. Rul. 60-32 voluntarily agreed to comply with procedures and requirements in exchange for valuable rights created and granted by governments or cash grants. Similarly, an offset project operator offers voluntary compliance with a set of procedures and requirements for collecting data and

[13] 136 T.C. 341 (2011), aff'd sub nom. Esgar Corp. v. Commissioner, 744 F.3d 648 (10th Cir. 2014).

monitoring GHG reductions or GHG removal enhancements as consideration in exchange for valuable rights created and granted by the CARB. As "[g]ross income includes income realized in any form, whether in money, property, or services" (Income Tax Regs. § 1.61-1(a)), the fact that compensation for a taxpayer's performance here consists of property (i.e., ARB offset credits) rather than cash is without significance.

The offset project operator is not required to retain ARB offset credits to operate a regulated trade or business. Nor is the CARB allocating a limited public resource to offset projects: the number of ARB offset credits increases every time the CARB grants one to an offset project operator complying with the terms of one or more approved offset protocols. In contrast, the rights granted the taxpayers in Rev. Rul. 67-135, Rev. Rul. 92-16, and GCM 39606 are necessary for them to conduct their regulated trades or businesses (that is, mining on federal lands, operating an electric utility and operating, or leasing FAA slots to, an airline). The rights granted the taxpayers in Rev. Rul. 67-135, Rev. Rul. 92-16, and GCM 39606 represent scarce resources that a government is responsible for allocating and are thus limited in quantity.

Further, an offset project operator that does not emit carbon cannot use an ARB offset credit for any purpose other than sale to a third party, unlike taxpayers who can reduce their own state income or property tax liabilities with state tax credits granted to them. Rev. Rul. 79-315, Rev. Rul. 78-194, Rev. Rul. 70-86, and Tempel suggest that the ARB offset credit in the hands of an offset project operator is similar to a cash refund received by a taxpayer that represents an excess of the state tax credit over the state tax liability.

An offset project operator who receives ARB offset credits from the CARB for voluntarily agreeing to an approved offset protocol has an undeniable accession to wealth. As the ARB offset credits are granted without restriction on the operator's ability to exercise complete control over them, the operator must include the value of the ARB offset credits in its gross income upon grant.

If there are any questions, please contact ITA Branches 4, 5, or 8.